CUMBERLAND

Strategy Review

August 2010

Something's Gotta Give

The month of August displayed yet another reversal in the prevailing sentiment regarding the sustainability of the U.S. economic recovery. As the majority of economic data reported last month came in largely weaker than expected, consensus opinion swung strongly back toward the "double dip" camp with some economists even arguing that we are mired in a depression. The knee jerk reaction to the swing in sentiment has been to sell equities and buy bonds. Certainly, that continued through August with U.S. Treasury yields plumbing new lows while the U.S. equity market gave back most of its gains from July. As we have stated in past letters, markets are likely to remain range bound until some semblance of certainty on the macroeconomic outlook globally, and for the U.S. especially, takes hold. In fact, as we write this letter just one week into September, much better than expected employment data has already driven the U.S. equity market substantially higher; recovering all of its August losses and it is now trading above where it closed in July.

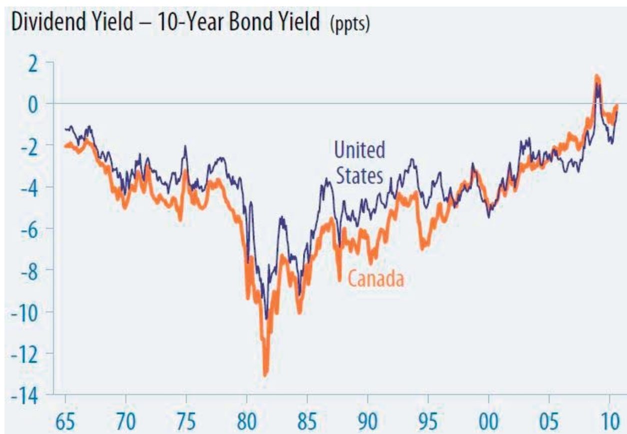
For the record, the S&P 500 fell in August by just under 5% but only 1.4% in Canadian dollar terms as the loonie declined almost 3.5% against the U.S. dollar. Canadian equity markets were resilient last month, actually rising 1.7% as rising gold prices (up 5.7%) and commodity strength driven by the takeover bid for Potash, pushed the index higher. Crude oil fell almost 10% back to the low US$70's on higher inventories and fears that a pending U.S. economic recession would lower demand. Finally, the honeymoon at US$1.30 appears to be over for the Euro as it fell by 3.5% on renewed concerns regarding the health of European banks.

Most amazing to us in the current investment climate is the almost total preoccupation with the macroeconomic outlook and the resulting very limited amount of discussion surrounding where to actually best invest capital. There is an attractive price for just about any financial instrument, and to our mind the more important analysis is to focus on which asset classes offer the most (or least) attractive prices today. Nobody knows for certain where the future will lead but we do believe the separation in potential risk and reward between bonds and equities has moved into the "historic" category. Granted, pricing inefficiencies can remain historic for longer than people expect, but good wealth managers will move their exposure over time to where the odds are most favourable. So with that, let's take a quick look at how we currently see the risk and reward across asset classes.

Traditionally, a pretty decent rule of thumb in valuing equities relative to bonds has been to compare the earnings yield of the equity market to the yield on the 10 year Treasury. Theoretically, fair value is when the two yields are equal although historically they spend significant amounts of time either undervalued or overvalued relative to each other. Another traditional relationship has been that bonds should yield some amount above the dividend yield on equities since equities also offer the opportunity to participate in growth over time. By both of these measures, equities continue to look favourable relative to bonds. Below is a chart (Figure 1) showing the difference between the dividend yield and the 10 year government bond for both the U.S. and Canada over the past 45 years. Over that period, the gov-

ernment bond yield has always been greater than the dividend yield by at least 200 basis points until this recent cycle. As of today, you can own the equity market and earn just about the same yield as if you bought a government bond. The right to any capital appreciation from growth in the economy and profits is essentially yours for free at this point as an equity holder.

Source: BMO Capital Markets



What about the relationship between the earnings yield of the equity market and the bond yield? Well, depending how conservative you want to be on this year and next year's earnings estimates, the S&P 500 now trades at between a 7.5% and 8.5% yield on 2010 earnings and between 8.0% and 9.0% on 2011. The 10 year Treasury on the other hand is trading at just a 2.5% yield, resulting in a valuation gap of truly historic proportions. Given fair value is considered to be equality between the two yields, in our view "something's gotta give". In fact, there are three possible outcomes:

1. It turns out the earnings estimates in the range quoted above are for real, in which case equity markets will rise in order to lower the earnings yield down to the 10 year Treasury.

2. It turns out the earnings estimates in the range quoted above are much too high, in which case lower earnings result in a lower earnings yield more in line with the 10 year Treasury without equity prices having to move anywhere.

3. The yield on the 10 year Treasury could rise from its 30+ year low, bring bond yields across the board higher with it, and approach parity with the earnings yield again.

In reality we expect some combination of the three to happen. Given current economic sluggishness, it seems unlikely that earnings across the S&P 500 can grow 13% in 2011, but just how low would they have to go to get the earnings yield to 2.5%? How about $25 instead of the $94 currently forecast by the street? To give that some perspective, reported earnings in 2008, including all the writeoffs, bottomed at $15. So, in our view, unless you believe we are headed back into the black hole of a global credit crisis, the odds seem to heavily favour either #1 or #3 as making a meaningful contribution to getting this relationship back in balance. Either way, both #1 and #3 argue for tipping allocation more toward equities than bonds at current prices.

Of course there is no way to know how long it may take for these relationships to move back into line and so our approach has been to gradually reduce our allocation to bonds and increase our allocation to equities. Within our income portfolios we have favoured corporate bonds over government bonds and have increased the allocation to higher yielding equities. In particular, we have focused on credit analysis to identify those issuers with credit

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prospects substantially better than their current spread. Within capital appreciation portfolios we have remained overweight Canada relative to the U.S. with an eye on growing U.S., and where appropriate, some global exposure going forward. Market turbulence and volatility are, in our view, unlikely to disappear anytime soon and so we will continue to do our best to implement our strategy while trying to take advantage of market panic and greed.

John Wilson
Chief Investment Officer
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